Commodities After The Fall

If you ever have had an urge to see what a horde of methamphetamine-laced undertakers might look like, cast your eyes upon the mob burying the purveyors of "hot commodities," including the fictional Bombastic Bowtie fund last seen in these precincts in March regularly losing money on the monthly roll in crude oil. Who knew how successful actual successors to the BB fund, such as Amaranth Advisors, would be in vaporizing billions of dollars of their investors' money?

Dracula and Rasputin did not go down after their first shaving cuts, and neither will these markets. Whatever else can be said regarding various commodity markets (as opposed to the misnomer, "commodities," as discussed here in May 2004), the case for long-term secular bull trends therein is a compelling one. We simply are in a corrective phase at the present time.

We can date the end of the commodity rally to May 12, 2006, an event noted here at the time with a column calling the metals rally a bubble. The Reuters/Jefferies CRB index had hit its peak of 365.45 on May 11th en route to its present value of 303.39, and the Dow Jones-AIG index peaked at 188.11 en route to 164.289. The energy-heavy Goldman Sachs index did not peak until July.

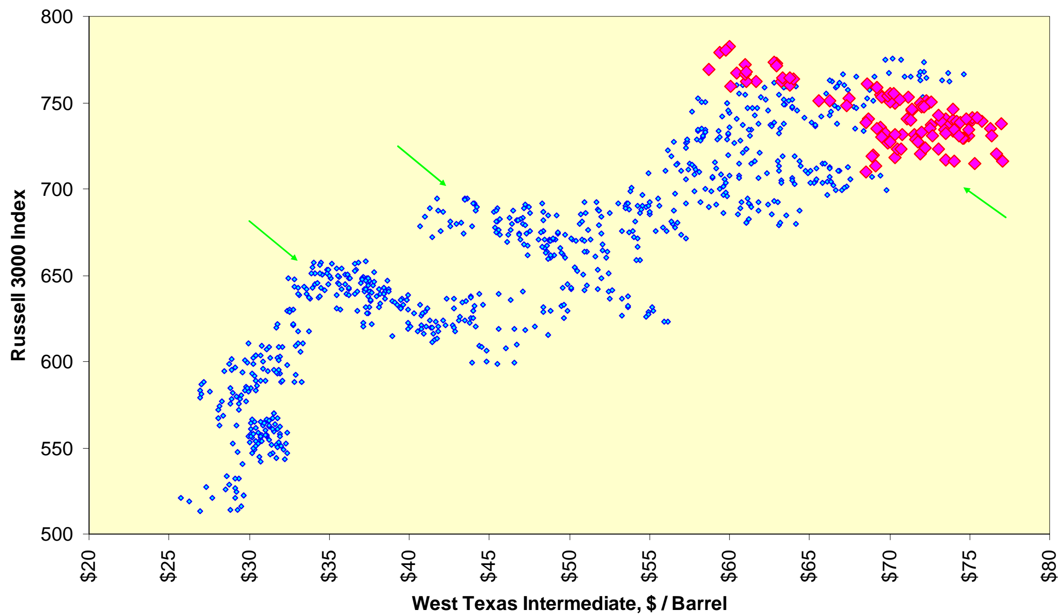
The timing of this peak was no accident; it coincided with the sudden and massive withdrawal of excess liquidity by the Bank of Japan, an event discussed here in July. Speculators often are accused of confusing a bull market for brains; a better categorization might be confusing the ability to play with someone else's cheap money for brains.

What Changed?

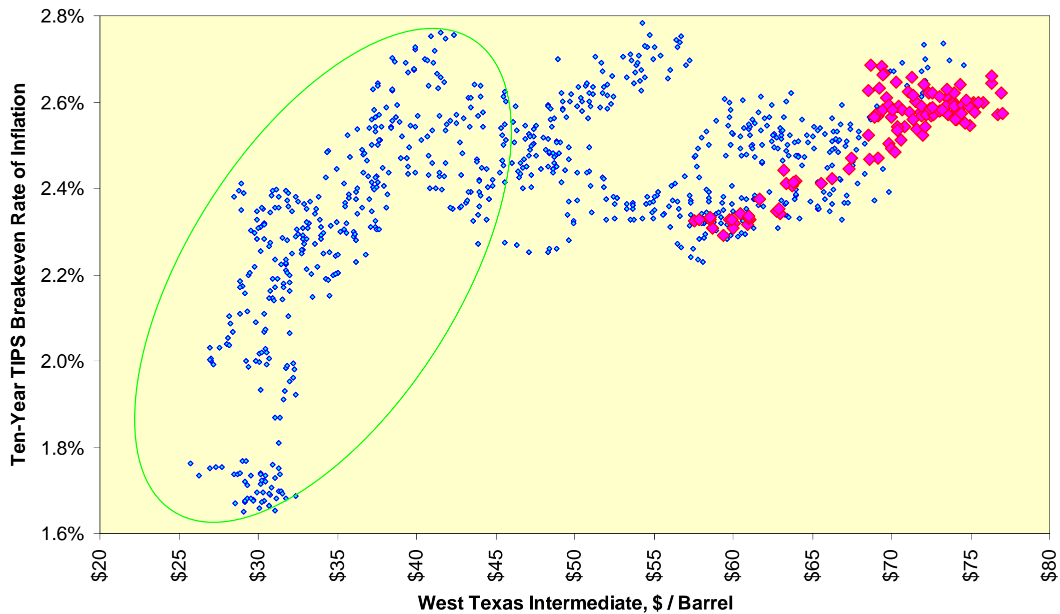
Now that we have put five months behind us and the world's financial markets have recovered from their Bank of Japan-induced wavering, let's ask the question what impact if any the downturns in various commodity prices have had on those financial markets. Surely there must be some reason why various business-oriented daytime television shows work themselves into such lather over every move, higher and lower, in crude oil, for example?

We can bind the commodities bubble with two dates, May 6, 2003, when the FOMC declared war on deflation (they won) and the aforementioned May 12, 2006. A very large data analysis was conducted comparing financial market / commodity pairs both in this date range, depicted with blue dots on all charts below with the post-May 12 observations, marked in magenta.

Crude oil is the largest physical commodity market and the one felt most directly by both individuals and industries. If we map the U.S. stock market as measured by the Russell 3000 index against it, we can see how the present episode of rising stocks during a crude oil price decline has occurred twice before, as marked on the chart with green arrows. In fact – and this is skipping over many statistical tests that could be done – we could conclude the course of U.S. stocks largely has been unaffected by the course of crude oil.



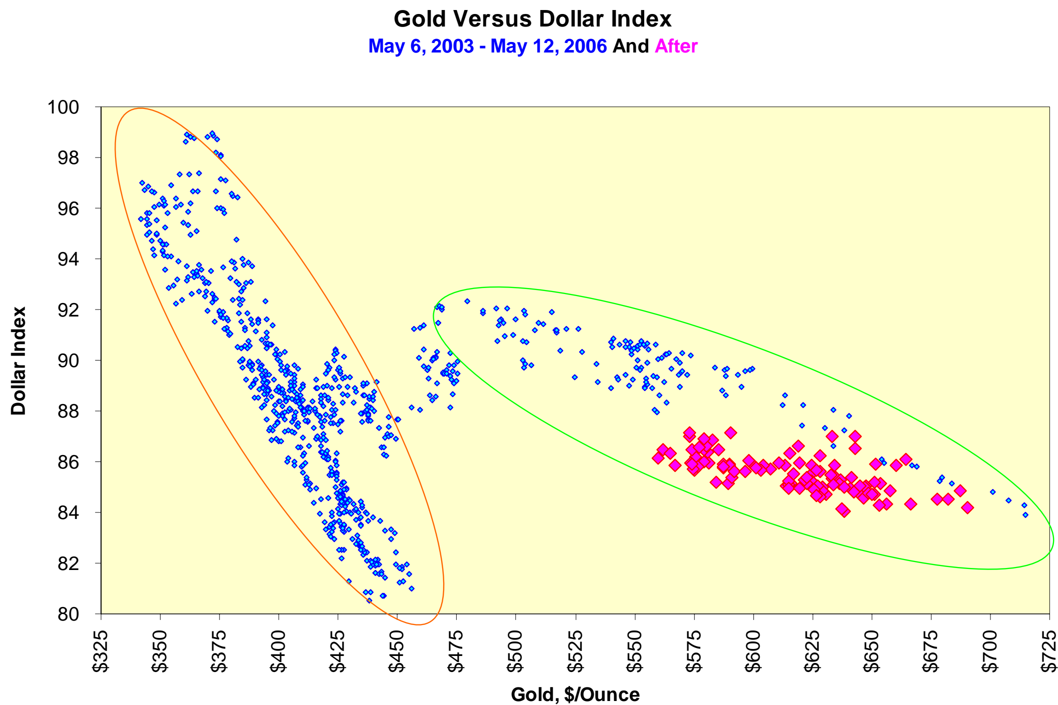
What about the relationship between crude oil and inflation expectations as measured by the TIPS market? The largest jump in TIPS-measured inflation occurred during the period when crude oil rose from the $25 range to the $45 range, noted with an oval. Inflation expectations have declined of late, true, as crude oil prices have fallen, but if this relationship truly were causal, they would have risen during crude oil's huge rally to the $75 range as well. They did not.



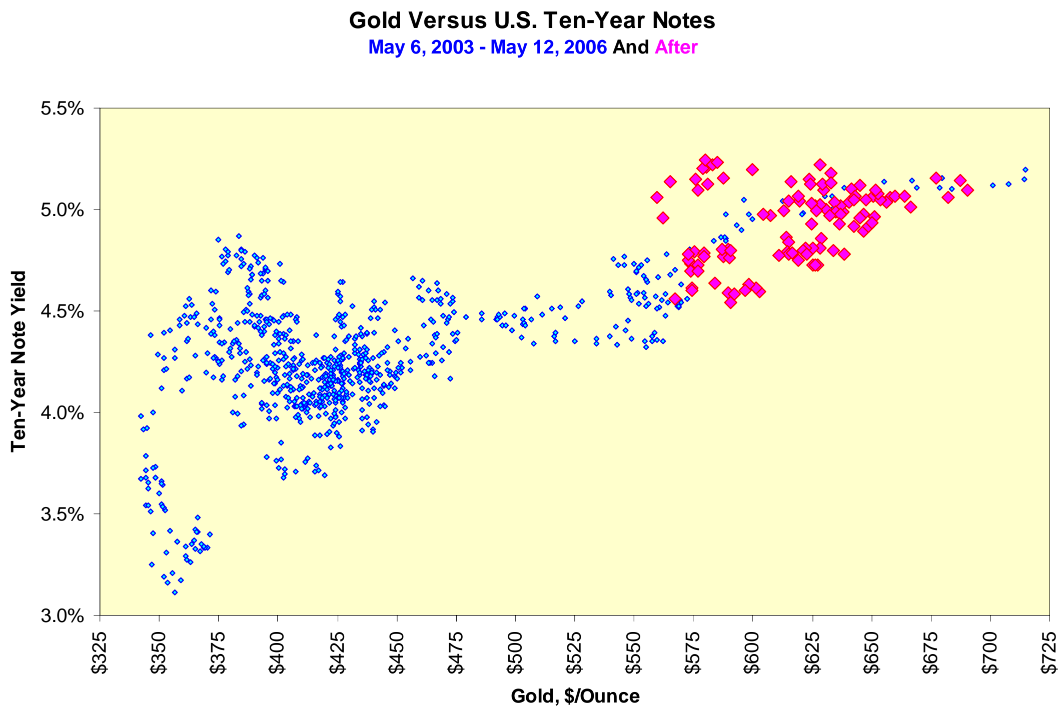
Gold

What about gold, a market alleged by its adherents to be "smart," whatever that means (As an idle thought, if these gold traders are so smart in one market, why aren't they that smart in their other endeavors? Kindness, I suppose). Gold and the dollar had a strong and near-linear relationship for many years, one I wrote about in June 2002. That was then; this is now. Once gold began its ascent over $475, the slope of the dollar's relationship thereto changed.

Gold ceased to be a dollar play – it ceased to be an inflation play as well, but that's another story – and while the dollar still moves inversely to gold, it is nowhere the given it was before.



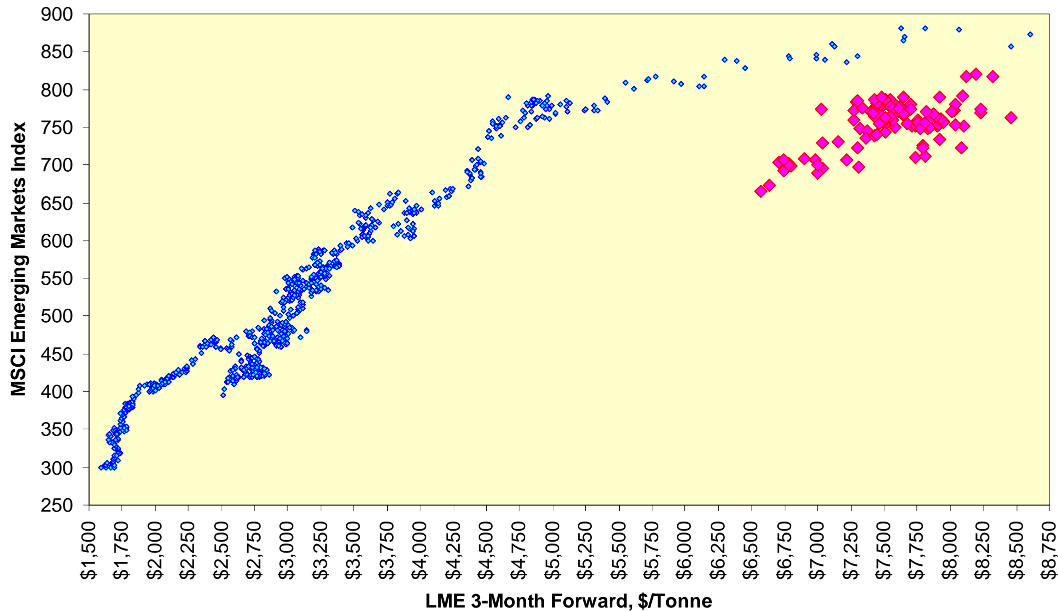
However, one relationship for gold remains constant, and that is with Treasury note yields. As gold prices rise, Treasury yields have risen along therewith. Gold bugs may take solace.



Copper And Growth

Many commentators striving to explain matters with soundbite nuance have sought to link the downturn in commodities with stagnant residential real estate prices in the U.S. Let's see…condo prices are no longer accelerating at silly rates in the Las Vegas desert, so the global economy must be headed south. Wow; people get paid to think like that.

Let's map the Morgan Stanley Emerging Market Free index against copper prices. Once the May 2006 break occurred, both markets stabilized simultaneously and simply resumed their previous relationship at lower levels of emerging market equities. The same global growth story propels both markets at the same rate, and all that is happened since May is a single adjustment to the Bank of Japan shock.



The net result of the large data study is the impact of various commodity prices on financial markets generally is random and near-zero. The charts above were selected by virtue of a visible relationship. The simple reality is commodities are small markets compared with financial market and represent a declining influence on the global economy. Too many people say "commodities" collectively when they really mean "what I paid for gasoline." So long as the world avoids a major recession, we still will have growing resource demands and the need for incrementally more expensive production facilities.

Will we have a lot of hot money tossed willy-nilly at funds purporting to invest in the collective entity of commodities? By all rights, no, but that logic will go by the wayside if money once again chases performance.